

U.S. Department of Labor

Assistant Secretary for
Employee Benefits Security Administration
Washington, D.C. 20210



October 23, 2014

J. Mark Iwry
Senior Advisor to the Secretary and Deputy Assistant Secretary
for Retirement and Health Policy
Department of the Treasury
1500 Pennsylvania Avenue, NW, Room 3044
Washington, DC 20220

Dear Mr. Iwry:

This responds to your request for the Department of Labor's (the Department) views on whether a series of target date funds (Funds) could serve as "qualified default investment alternatives" within the meaning 29 CFR §2550.404c-5 (the QDIA regulation), in light of the Funds' investments in unallocated deferred annuity contracts, described in Internal Revenue Service (IRS) Notice 2014-66 (the Notice). You also ask whether, and to what extent, the Department's "annuity selection safe harbor," 29 CFR §2550.404a-4, is available in connection with the selection of the unallocated deferred annuity contracts as investments of the Funds. You indicate that plan sponsors have raised these questions with the Department of the Treasury.

The Notice describes a profit-sharing plan (the Plan) qualified under section 401(a) of the Internal Revenue Code (Code). Participants in the Plan can commence distribution at age 65, the normal retirement age under the Plan, or upon severance from employment. The Plan provides for the allocation of investment responsibilities to participants and beneficiaries. The Plan offers an array of designated investment alternatives, including the Funds. The Funds are designed to provide varying degrees of long term appreciation and capital preservation through a mix of equity and fixed income exposures based on generally accepted investment theories. The Funds' asset mix is designed to change over time, becoming more conservative through a gradual reduction in the allocation to equity investments and a gradual increase in the allocation to fixed income investments as the participants in each Fund become older.

The intent of the plan sponsor is to satisfy the conditions of the QDIA regulation. Thus, for example, participants may transfer their holdings, in whole or in part, from the Funds to other investment alternatives available under the Plan on at least a quarterly basis. The Funds do not impose any fees or restrictions on the ability of a participant to transfer his or her holdings, in whole or in part, to other investments available under the Plan, or to make withdrawals pursuant to section 414(w)(2)(B) of the Code, during the 90-day period beginning with the initial investment of a participant's assets in the Fund. Following the end of this 90-day period, the Funds do not have any transfer or withdrawal restrictions or fees that differ depending on whether the particular participants affirmatively selected the Funds, rather than having been defaulted into the Funds.

Each Fund within the series is available only to participants who will attain normal retirement age within a limited number of years around the Fund's target date.¹ Each Fund available to participants age 55 or older holds unallocated deferred annuity contracts, which constitute a portion of the Fund's fixed income investments. Funds with such annuities normally do not permit participants whose ages fall outside the designated age band for the Fund to hold an interest in that Fund, because it is not actuarially reasonable for an insurer to offer a deferred annuity at a price that does not vary based on the age of the purchaser. As the age of the group of participants in such Fund increases, a larger portion of the assets in the Fund will be used to purchase unallocated deferred annuity contracts each year. Funds that are available to participants younger than age 55 do not include unallocated deferred annuity contracts. However, the series is designed so that as the asset allocation changes over time, each Fund will include unallocated deferred annuity contracts beginning when the participants in that Fund attain age 55.

An "unallocated deferred annuity contract" is a contract with a licensed insurance company that promises to pay income to covered plan participants at some date in the future (possibly far into the future) on a regular basis for a period of time or for life. The annuity is written on behalf of a group of participants and not issued to and owned by a specific individual. As such, unallocated deferred annuity contracts do not ordinarily require the insurance company to have or maintain any personal information on individuals in the group. Rather, units of the unallocated annuity generally are largely interchangeable among members of the covered group, which facilitates transferability and allocation within the group, for example at the dissolution date of each Fund.

At its target date, each Fund dissolves, and participants with an interest in the Fund will receive an annuity certificate providing for immediate or deferred commencement of annuity payments. The certificate represents the participant's interest in the unallocated deferred annuity contracts held by the Fund. For instance, if a Fund's asset mix contains a fifty percent investment in unallocated deferred annuity contracts, then half of each participant's individual account balance will be reflected in the certificate. The remaining portion of each such participant's interest in the Fund will be reinvested by the participant or plan fiduciary in other Plan investment alternatives in accordance with title I of the Employee Retirement Income Security Act of 1974, as amended (ERISA).

The assets of the Funds include plan assets for purposes of part 4 of title I of ERISA and such Funds are managed by an investment manager as described in section 3(38) of ERISA. The investment manager has complete discretion to manage, acquire, or dispose of any assets of the Funds, including the unallocated deferred annuity contracts held by the Funds, and complete discretion to choose and retain the insurance company or companies issuing the contracts. The investment manager is independent from the insurance company or companies issuing such contracts. The investment manager acknowledges in writing that he is a fiduciary with respect to the Plan.

The Notice responds to plan sponsors' concerns that making the deferred annuity available only to older participants could violate the current availability and effective availability requirements for benefits, rights, and features under Code section 401(a) and Treasury Regulation section 1.401(a)(4)-4. The Notice provides that, if specified conditions are satisfied, the series of Funds, in

¹ For example, the 2020 Fund is restricted to participants who will attain normal retirement age within a limited number of years (e.g., 3 years) around 2020.

which some of the Funds are restricted to participants in particular age bands, may be treated as a single “other right or feature” for purposes of Treasury Regulation section 1.401(a)(4)-4.² You have asked the Department to address the treatment of the Funds under the Department’s QDIA and annuity selection safe harbor regulations. Accordingly, the Department’s views on the application of these regulations to the Funds are discussed below.

QDIA Regulation

The QDIA regulation implements ERISA section 404(c)(5). Under this section, a participant or beneficiary in an individual account plan who fails to provide investment directions for his or her account will be treated as exercising control over assets in the account, if the plan fiduciary complies with certain notice requirements and invests the assets in accordance with regulations prescribed by the Department. The QDIA regulation requires, among other things, that participants on whose behalf the investment is made had the opportunity to direct the investment of the assets in their account but did not, and that they are furnished a notice describing the circumstances under which their assets may be invested in the QDIA, their right to direct the investment of their assets into any other plan investment alternatives, and the investment objectives, risk and return characteristics, and fees and expenses attendant to the QDIA.

The QDIA regulation also describes the attributes necessary for an investment fund, product, model portfolio, or managed account to be QDIA. A target-date fund that meets the specific requirements of the regulation is a type of fund that could be a QDIA. 29 CFR §2550.404c-5(e)(4)(i). Among other things, such a fund must be designed to produce varying degrees of long-term appreciation and capital preservation through a mix of equity and fixed income exposures based on the participant's age or target retirement date. In the Department's view, the use of unallocated deferred annuity contracts as fixed income investments, as described in the Notice, would not cause the Funds to fail to meet the requirements of paragraph (e)(4)(i) of the QDIA regulation. It is also the Department's view that the distribution of annuity certificates as each Fund dissolves on its target date is consistent with paragraph (e)(4)(vi) of the QDIA regulation. This section provides that an investment product will not fail to be a QDIA “solely because the product or portfolio is offered through variable annuity or similar contracts or through common or collective trust funds or pooled investment funds and without regard to whether such contracts or funds provide annuity purchase rights, investment guarantees, death benefit guarantees or other features ancillary to the investment [product.]”

Annuity Selection Safe Harbor

Under the annuity selection safe harbor, the selection of an annuity provider and contract for benefit distributions from an individual account plan satisfies the requirements of section 404(a)(1)(B) of ERISA if the fiduciary: (1) Engages in an objective, thorough and analytical search for the purpose of identifying and selecting providers from which to purchase annuities; (2) Appropriately considers information sufficient to assess the ability of the annuity provider to make all future payments under

² See I.R.S. Notice 2014-66 (entitled Lifetime Income Provided Through Target Date Funds in Section 401(k) Plans and Other Qualified Defined Contribution Plans).

the annuity contract; (3) Appropriately considers the cost (including fees and commissions) of the annuity contract in relation to the benefits and administrative services to be provided under such contract; (4) Appropriately concludes that, at the time of the selection, the annuity provider is financially able to make all future payments under the annuity contract and the cost of the annuity contract is reasonable in relation to the benefits and services to be provided under the contract; and (5) If necessary, consults with an appropriate expert or experts for purposes of meeting these conditions.

The sponsor of the Plan described in the Notice, acting as the Plan's named fiduciary, designated an investment manager (within the meaning of section 3(38) of ERISA) to manage the investments of each Fund, including the selection of the provider and the unallocated deferred annuity contracts. The selection of the provider and the unallocated deferred annuity contracts by the investment manager is a fiduciary decision governed by the provisions of part 4 of title I of ERISA. The annuity selection safe harbor sets forth an optional means for satisfying the fiduciary responsibilities under section 404(a)(1)(B) of ERISA with respect to the selection of an annuity provider or contract for benefit distributions. Consequently, the selection of the provider and the unallocated deferred annuity contracts satisfies the requirements of section 404(a)(1)(B) of ERISA if the designated investment manager satisfies each of the conditions of the annuity selection safe harbor. The plan sponsor, as the appointing fiduciary, must prudently select the investment manager and appropriately monitor the selection at reasonable intervals to assure the prudence of maintaining the appointment. After the investment manager is appointed, however, the investment manager is responsible for the prudent management of the plan's assets and selection of the unallocated deferred annuity contracts. Assuming the plan sponsor appropriately discharges its duties as the appointing fiduciary, it will not be liable for any acts or omissions of the investment manager, except for any potential co-fiduciary liability under section 405(a) of ERISA.

Conclusion

The use of unallocated deferred annuity contracts as fixed income investments, as described in the Notice, would not cause the Funds to fail to meet the requirements of paragraph (e)(4)(i) of the QDIA regulation. The selection of the unallocated deferred annuity contracts satisfies the requirements of section 404(a)(1)(B) of ERISA if the designated investment manager satisfies each of the conditions of the annuity selection safe harbor. The plan sponsor, as the appointing fiduciary, must prudently select the investment manager and monitor the selection at reasonable intervals, in such manner as may be reasonably expected to ensure that the investment manager's performance has been in compliance with the terms of the Plan and statutory standards, and satisfies the needs of the Plan.

We hope this information will be of assistance to you.

Sincerely,

Phyllis C. Borzi
Assistant Secretary